


**SAN DIEGO CITY EMPLOYEES' RETIREMENT SYSTEM**  
**MEMORANDUM**  
**COMPLIANCE DIVISION**

**DATE:** December 21, 2007  
**TO:** Board of Administration  
**FROM:** Roxanne Story Parks,  Chief Compliance Officer  
**SUBJECT:** Voluntary Correction Program -- Compliance Statement

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The Internal Revenue Service has issued a Compliance Statement to SDCERS, which is the final resolution of SDCERS' Voluntary Correction Program (VCP) filings. A copy of the Compliance Statement is attached.

SDCERS made its initial VCP filing on July 12, 2005. Between July 2005 and August 2006, SDCERS tax counsel, Ice Miller, worked with SDCERS staff to complete an exhaustive review of SDCERS' operations and plan documents, to identify all instances where SDCERS was not being operated consistently with federal tax law. As a result of this review, SDCERS filed 8 supplemental VCP filings, identifying violations and proposing corrections concerning: compensation limits under Internal Revenue Code (IRC) section 401(a)(17); minimum distribution requirements under section 401(a)(9); eligible rollover distribution compliance under IRC section 401(a)(31); minimum required distributions from the Deferred Retirement Option Plan (DROP) program; overpayment of disability benefits; conversion of annual leave to purchase service credits; retiree healthcare benefits and health administrative expenses under IRC section 401(h); benefit and compensation limits under sections 415(b), 415(c) and 415(n); and remedial plan amendments.

SDCERS has been working cooperatively with the IRS to resolve all of the VCP filings, and this Compliance Statement is the culmination of that effort. We are pleased with the Compliance Statement because it:

- Protects employees, retirees, and taxpayers by preserving the qualified status of the SDCERS Plan; and
- Protects taxpayers because the IRS is not seeking any penalty payments, and is not requiring the City to make any additional contributions.

The Compliance Statement identifies 14 failures and corrections, each of which is summarized below.

### **Failures 1, 2 and 3 (Plan Document Failures):**

The City's Plan document, as contained in the San Diego Municipal Code and San Diego City Charter, was not timely amended by the City to comply with federal tax legislation that amended IRC section 401(b) and the Treasury Regulations issued under that section.

### **Corrections Related to Failures 1, 2 and 3:**

The City must correct these failures by adopting the IRS-approved Tax Compliance Ordinance, a redline copy of which is attached to this report. The Tax Ordinance amends the City's Plan retroactively to comply with all of the subject tax laws. The Board must also adopt the attached Board Rules, which have been reviewed and approved by the IRS. The City Ordinance must be adopted within 150 days of the date the Compliance Statement is fully executed. (SDCERS will prepare similar amendments for the Port and Airport to adopt within the 150-day period.)

In addition, SDCERS is working with Ice Miller to identify any other necessary amendments. In the future, SDCERS and the City will work together to ensure that the Plan document is updated in a timely manner for tax law changes.

### **Failure 4 (Incumbent Presidential Leave Program):**

From 1989 until February 2004, SDCERS accepted contributions from three of the labor unions that represent City employees. And, in 2002, the City Council adopted a Resolution providing a special presidential leave benefit (the "Incumbent President Program") to four current and past presidents of these three unions (the "incumbent presidents").

The incumbent president Resolution provided, with respect to the four incumbent presidents, that their "high one-year salary" for calculating a service retirement, and their employer and employee retirement contributions, would be based upon their union salaries or their combined union and City salaries, not to exceed the annual base salary of the City's Labor Relations Manager. In addition, the Resolution provided that the incumbent presidents' union service would be counted as service credit in the City's Plan.

SDCERS stopped accepting union contributions in February 2004. In its VCP filing, SDCERS committed to accept contributions only from the City and other governmental employers participating in the Plan.

#### **Corrections Related to Failure 4:**

The City must amend the Plan retroactively to remove all provisions relating to presidential leave, including the Incumbent President Program. The amendments will indicate that benefits and participation under the City's Plan are limited to City employees, and that retirement benefits will be based solely on compensation associated with City service. These amendments are part of the IRS-approved Tax Ordinance.

All employee contributions that were paid to the Plan directly by the unions or derived from Union-paid compensation must be returned to the affected plan participants with accumulated interest. The distribution of these monies will be taxable to each affected participant and will not be subject to any favorable tax treatment. SDCERS must also return to the unions all employer contributions the unions paid to the Plan.

SDCERS will recalculate the benefits of all impacted participants and update their records to reflect their reduced benefits and service credits. The benefits must be determined based solely on City service and compensation. For the one impacted participant who has retired, the monthly annuity currently being paid will be reduced to the recalculated amount. SDCERS will recover the overpayments that have been made to this participant via an offset against the return of employee contributions, by direct repayment to the Plan or by an actuarial reduction to the reduced monthly pension benefit on a going forward basis.

The three remaining impacted participants are currently in DROP. The monthly benefit payments into their DROP accounts will be recalculated and reduced on a going forward basis. Also, their DROP accounts will be recalculated and reduced so that their benefits are based solely on City service.

#### **Failure 5:**

This filing addressed a benefit negotiated in 2002 "meet and confer" between the City and the International Firefighters' Union, Local 145. Members represented by Local 145 were allowed to convert to service credit the "cash equivalent" of the accumulated annual leave that they earned after June 30, 2002. SDCERS stopped allowing "cashless leave conversions" on April 25, 2006.

The IRS has determined that the Cashless Leave Conversion Program is an impermissible "cash or deferred arrangement," in violation of IRC section 401(a).

#### **Corrections Related to Failure 5 (Cashless Leave Conversion Program):**

The City must amend the Plan retroactively to remove all provisions related to the Cashless Leave Conversion Program. The necessary amendments are in the Tax Ordinance.

In addition, SDCERS must recalculate the service credit for all participants who took part in the Cashless Leave Conversion Program to remove all service purchased under the program.

There are 43 members who purchased service credit under the Cashless Leave Conversion Program, of whom 24 are active members, 18 are participating in DROP and one is retired. For the affected members who are currently in DROP, the monthly benefit payments into their DROP accounts will be reduced on a going forward basis, and their DROP accounts will be recalculated and reduced. For the one retired member, the monthly benefit will be reduced to the recalculated amount and SDCERS will recover the overpaid amount by further reducing the revised monthly pension benefit.

The City can not adopt any future amendments to the Plan that would result in a cash or deferred arrangement. SDCERS will ensure that future changes to the Plan comply with IRC section 401(a).

#### **Failures 6 and 7 (Retiree Health Benefits):**

During the plan years ending in 1983 through 1991, retiree health benefits were paid by SDCERS, even though the terms of the Plan did not provide for such benefits. In addition, the City failed to reimburse SDCERS for expenses associated with administering the retiree health benefit account from 1993 through 2006. Both actions violated IRC section 401(a)(2). The accumulated amount of these improper payments (including interest) is \$33,830,251.

In addition, during the plan years ending in 1998 through 2005, the terms of the Plan and its operation did not comply with all requirements of IRC sections 401(a)(2) and 401(h), as they relate to health benefits, because the terms of the Plan provided that earnings of the trust would ultimately be used to fund retiree health benefits. This resulted in the underfunding of the Plan. Although retiree health benefits were paid from the Plan's 401(h) retiree health account as required by the Code, it is difficult if not impossible to confirm that there was no inappropriate use of the Plan's assets.

Effective July 1, 2005, retiree health benefits are no longer paid out of the Plan's 401(h) account. Instead, these benefits are being paid directly by the City.

#### **Corrections Related to Failures 6 and 7:**

The IRS has agreed that the City has corrected fully the underfunding with respect to retiree health benefits by having made supplemental contributions to the Plan that exceed the actuarial required contributions during the plan years ending in 2006, 2007 and the current plan year.

The City and SDCERS agree that the payment of retiree health benefits must be funded by separately designated employer contributions and cannot be funded from pension assets, including plan earnings. To codify this change, the City will amend the Plan to remove retroactively the provisions relating to the 401(h) account effective as of July 1, 2005. These amendments are included in the Tax Ordinance.

**Failure 8 (Required Minimum Distributions):**

SDCERS did not comply with IRC section 401(a)(9) regarding required minimum distributions for Plan participants who were owed a lump sum or partial lump sum distribution during plan years that ended in 1989 through 2004.

**Corrections Related to Failure 8:**

No annuity payments were paid in violation of the minimum distribution requirements, and the lump sum and partial lump sum payments to participants who were past their required beginning dates have been paid. In addition, SDCERS has implemented a new annual monitoring system that will ensure that all required minimum distributions begin on a timely basis with respect to all types of Plan participants and beneficiaries.

**Failure 9 (Compensation Limits):**

During the plan years that ended in 2000 through 2005, SDCERS calculated the retirement benefits for three participants using participant compensation that exceeded the IRC section 401(a)(17) limit. (Section 401(a)(17) limits the amount of annual compensation a qualified plan may "take into account under the plan for any year." A defined benefit plan may not base benefit accruals on compensation above the limit.)

**Corrections Related to Failure 9:**

For one of the three affected participants, who terminated without a vested pension, the failure only resulted in excess contributions being made by the participant. The excess contributions, which totaled \$420.89, were paid to the participant as a lump sum in 2002.

For the other two affected participants, SDCERS will recalculate their benefits and update SDCERS' records to reflect the reduced benefits. SDCERS will distribute the excess employee contributions plus interest to the affected participants. The distributions will be taxable and cannot be rolled over. SDCERS will report the distributions on forms 1099-R.

SDCERS has revised its software, testing protocols and internal reports to monitor participant compensation. Employee contributions will be stopped when

they reach the 401(a)(17) limit, and no retirement benefits will be based on the excess compensation.

**Failure 10 (Rollover Distribution Notices):**

During the plan years that ended in 2002 through 2006, SDCERS violated IRC section 401(a)(31) by failing to give the proper rollover notices to individuals who received eligible rollover distributions from the Plan.

**Corrections Related to Failure 10:**

The City will amend its Plan to include language that allows it to meet the IRC section 401(a)(31) requirements. This is included in the Tax Ordinance. SDCERS has created detailed written procedures to ensure that notices will be provided with all future eligible rollover distributions. Using a detailed chart, SDCERS staff has been trained regarding the benefits of the Plan that are eligible rollover distributions.

**Failure 11 (Disability Overpayments Related to Corbett):**

During the plan years that ended in 2001 through 2006, SDCERS failed to follow the terms of the Plan by paying disability retirement benefits to non-service-eligible disability retirees in excess of the formula set forth in the plan document. Specifically, SDCERS increased these members' final compensation amount by 10% and used this revised figure to determine the benefits. (This was due to a misinterpretation of the Corbett Settlement Agreement.) SDCERS has determined that overpayments were made to 146 participants and that the accumulated amount of the overpayments, including interest, is \$1,221,543.

**Corrections Related to Failure 11:**

SDCERS stopped paying the excess disability benefits in July 2006. The City has fully reimbursed the Plan for the overpayments, plus interest, by having made supplemental contributions to the Plan, above the City's mandatory actuarial required contributions, during the plan years ending in 2006, 2007 and 2008.

**Failure 12 (Benefits Paid in Excess of 415(b) Limits):**

During the plan years that ended in 1996 through 2007, SDCERS allowed the Plan to pay benefits that exceeded the limits imposed by IRC section 415(b). Overpayments were made to approximately 58 participants and the accumulated amount of the overpayments plus interest associated with this failure is approximately \$4,209,221 (\$3,779,221 for the 58 identified participants plus \$430,000, which is an estimate of the payments that may have been made to participants who died during the past 5 years).

### **Corrections Related to Failure 12:**

The IRS has accepted the testing methodology set forth in SDCERS' "415(b),(c) and (n) Compliance Strategy Report," which is incorporated into the Compliance Statement. SDCERS will not make payments in excess of the 415(b) limits beginning in fiscal year 2008. SDCERS will reduce the payments being made to current retirees and beneficiaries to the extent necessary to comply with the section 415(b) limits.

The IRS has accepted SDCERS' position that repayment of the amounts paid above the 415(b) limits should not come from the affected participants, since the City is obligated to pay these excess benefits due to the existence of IRC section 415(m) (authorizing the use of a Qualified Excess Benefit Arrangement to pay excess benefits) and the laws of the State of California.

The City has reimbursed fully the Plan for the overpayments, plus interest, by having made supplemental contributions to the Plan, above the City's mandatory actuarial required contributions, during the plan years ending in 2006, 2007 and 2008.

SDCERS has revised its administrative procedures to ensure the Plan's compliance with the section 415(b) limits, as described in the "415 (b), (c) and (n) Compliance Strategy Report."

### **Failure 13 (Domestic Partner Benefits):**

Since January 1, 2005, SDCERS has provided spousal death benefits to registered domestic partners, even though these benefits were not provided for in the City's Plan until February 16, 2007. (This resulted from the City's failure to timely amend the City's plan to comply with the California Domestic Partner Act, which took effect on January 5, 2005.)

### **Corrections to Failure 13:**

The City must amend the City's Plan to provide domestic partner benefits retroactive to January 1, 2005. SDCERS will not administer the plan or provide benefits in a manner that is not explicitly authorized by the Plan. If SDCERS believes the Plan must be amended, it will work with the City to have the Plan amended before changing the Plan's operations.

### **Failure 14 (Annual City Contributions to SDCERS):**

The Gleason Settlement Agreement required the City to make payments as specified in the Settlement Agreement for fiscal years 2005 through 2008, and to "repeal those portions of the San Diego Municipal Code section 24.0801 enacted November 18, 2002, which specify the rates the City pays [to the Retirement

Fund on behalf of City employees] are as agreed in the governing Memorandum of Understanding between the City and SDCERS." The referenced MOU is commonly referred to as Manager's Proposal II.

The City has not amended Municipal Code section 24.0801, and that section still provides that the City's annual contribution to SDCERS is based upon the [Manager's Proposal II] MOU. Thus, the City's annual payments to SDCERS since fiscal year 2005 have been inconsistent with the language in the Plan document.

#### **Corrections Related to Failure 14:**

The City will retroactively amend the City's Plan to indicate that, effective July 26, 2004, the amount of employer contributions that must be paid to the Plan will no longer be based upon any MOU between the City and SDCERS.

#### **Enforcement Resolution:**

The IRS will not pursue the sanction of plan disqualification because of the failures described in the Compliance Statement. In addition, the IRS will waive the excise tax under IRC section 4974 that would otherwise be due based upon Failure 8 (Required Minimum Distributions). The IRS is not assessing any penalties against SDCERS or the City, and is not requiring the City to make any payments in addition to the supplemental contributions the City has already made to the Plan.

The Compliance Statement is conditioned on their being no misstatement or omission of material facts in the VCP submissions, and the completion of all required corrections within 150 days of the date the Compliance Statement is fully executed.